ISDA Safe, Efficient Markets

BY EMAIL

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European Banking Authority
Level 46, One Canada Square
Canary Wharf
London E14 5AA
United Kingdom

Ladies and Gentlemen

ISDA comments on the European Banking Authority's consultation paper on draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive (BRRD) (EBA/CP/2014/33)

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to provide input to the European Banking Authority's (the **EBA**) consultation paper on draft Regulatory Technical Standards (**draft RTS**) on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive (BRRD) (EBA/CP/2014/33) published on 5 November 2014 (the **Consultation**). ISDA is also grateful for the opportunity to have participated in the EBA's open hearing on the consultation held on 9 January 2015 (the **Open Hearing**).

Consistent with our mission, we are primarily concerned in this letter with the impact of the proposed implementation on the safety and efficiency of the financial markets. We therefore focus on the direct impact of the proposals on the rights of a market counterparty under its derivative and other financial transactions with a failing firm and under related netting and collateral arrangements. We are aware that a number of other market associations and professional bodies will be responding on some of the broader issues raised by the Consultation.

ISDA broadly supports the EBA's proposals for the provisions of the draft RTS. ISDA also appreciates the limits of the EBA's mandate, and agrees with the EBA's conclusion that it is not open to the EBA to propose new grounds for exclusions from the scope of the requirement to include contractual recognition language under Article 55(1) (the **Contractual Recognition Requirement**).

However, in common with other stakeholders, we have some concerns with the terms of the draft RTS as presently drafted. In particular, ISDA considers that the EBA's further determination of the exclusion under Article 55(1)(d) in fact narrows the scope of that

[1] Information regarding ISDA is set out in Annex 1 to this response.

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD, United Kingdom
P 44 (0) 20 3088 3550 F 44 (0) 20 3088 3555
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

exclusion beyond what can reasonably have been meant by the level 1 text. Our concerns in this regard are further detailed in response to question 1 below.

ISDA considers that it is critical for the EU bank recovery and resolution framework to develop in a manner that is fully consistent with international standards and for this reason, we have referred in our response to the Financial Stability Board's (**FSB**) Key Attributes of Effective Resolution Regimes for Financial Institutions published 15 October 2015 (the **Key Attributes**), a copy of which is available at: http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf.

We hope that you find our comments useful in your continuing deliberations on the implementation of the draft RTS. Please do not hesitate to contact either of the undersigned if we can provide further information about the derivatives market or other information that would assist the EBA in its work in relation to the effective implementation of the BRRD requirements.

Yours faithfully

Dr Peter M Werner
Senior Director
pwerner@isda.org

Edward Murray
Chairman, ISDA Financial Law Reform Committee
ed.murray@allenovery.com

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QUESTIONS

1. Do you agree with the approach the EBA has proposed for the purposes of further determining points (a) and (d) of the first subparagraph of Article 55(1) of the BRRD (which form part of the list of liabilities to which the exclusion in Article 55(1) of the BRRD applies)? In particular, it is to be noted that Article 3(2) of the draft RTS refers to liabilities that 'may' become unsecured. Respondents are invited to comment on this approach and, should they disagree with this proposal, suggest possible alternative approaches.

On the basis of the discussion at the Open Hearing, ISDA understands that the primary driver for the current drafting of Article 3(2) and 3(3) of the draft RTS is to limit scope for regulatory arbitrage – in other words, the risk that institutions and relevant firms may enter into arrangements that give rise to liabilities in a manner which ensures that those liabilities are not eligible for bail-in. ISDA submits that the EBA's concern regarding regulatory arbitrage is misplaced in the current environment.

Institutions are soon to become subject to requirements that they hold a minimum amount of eligible (i.e. suitable for bail-in) liabilities (**MREL**). Those institutions for which bail-in is a significant component of their resolution strategy expect to have to hold large quantities of MREL and therefore are seeking to find ways to ensure that existing liabilities (and indeed new liabilities) will in fact be eligible for bail-in. Institutions and relevant entities wish to avoid the potentially punitive impact of a finding that they are not resolvable – including business, legal, structural and operational change under Article 17 of the BRRD – and thus can be expected to seek to ensure that a substantial proportion of their liabilities are eligible for bail-in.

Article 3(2) of the draft RTS: exclusion of secured liabilities

Article 55(1)(a) of BRRD confirms that the Contractual Recognition Requirement shall not apply to liabilities which cannot be bailed-in by virtue of their being excluded under Article 44(2) of BRRD.

Article 44(2)(b) excludes secured liabilities from the scope of bail-in, but the third subparagraph of Article 44(2) goes on to state that this shall not "prevent resolution authorities, where appropriate, from exercising those powers in relation to any part of a secured liability or a liability for which collateral has been pledged that exceeds the value of the assets, pledge, lien or collateral against which it is secured." For the purposes of this response, the part of the secured liability which exceeds the value of the security is referred to as the **Excess Liability**.

Article 3(2) of the draft RTS states:

> *For the purposes of point (a) of the first subparagraph of Article 55(1) of Directive 2014/59/EU, a liability shall not be excluded to the extent that it is, or may become, unsecured in part or in full even if the liability was at the point of its creation fully secured.*

ISDA considers that Article 3(2) as drafted may prove to be unworkable.

In the first instance, ISDA questions the interpretation of Article 44(2) that underpins Article 3(2) of the draft RTS: it is clear that secured liabilities are excluded; it is not clear that the third subparagraph of Article 44(2) narrows the scope of that exclusion. A possible alternative interpretation is that all secured liabilities are excluded from bail-in, but the Excess Liability may nonetheless be subject to the write-down and conversion powers.

ISDA notes that the Key Attributes confirm that bail-in should apply to claims of unsecured creditors. An "unsecured creditor" is ordinarily understood to be a creditor who does not have the benefit of any security. Secured counterparties to institutions and relevant entities will therefore ordinarily expect that liabilities due to them will not be subject to bail-in. Whether this is an accurate understanding of the law or not is somewhat irrelevant – there will undoubtedly be a significant impact on institutions and relevant entities seeking to meet the Contractual Recognition Requirement in arrangements under which secured liabilities arise, as they educate their counterparties regarding the risks those counterparties face. This impact is disproportionate to the benefit that may be derived from a possible bail-in of the Excess Liability.

Secondly, even if the EBA's interpretation of Article 44(2) is correct, such that the Excess Liability is not excluded, ISDA is concerned that the application of the Contractual Recognition Requirement to any liability which "may become" unsecured in part is unduly burdensome. Derivatives liabilities, and many other ordinary course banking business liabilities, are commonly secured by cash (which may be in a different currency to the currency in which the liability is itself denominated (for this purpose, referred to as **foreign currency**) and/or financial collateral. Where foreign currency or financial collateral is accepted, it will commonly be subject to a haircut, so as to allow for fluctuations in the value of that collateral. Notwithstanding such haircuts, it is difficult to conceive of a situation where the possibility of foreign currency or financial collateral dropping below the value of the liability could be entirely excluded. For this reason, traded products contracts, such as the ISDA Master Agreement, will ordinarily provide secured counterparties with a right to call for additional collateral in the event that the value of existing collateral diminishes below a certain threshold.

ISDA therefore submits that the impact of Article 55 on secured liabilities might be mitigated to a significant extent, and with minimal practical impact on the scope of liabilities that would be available for bail-in at any particular point in time, if Article 3(2) of the draft RTS were to be recast as follows:

For the purposes of point (a) of the first subparagraph of Article 55(1) of Directive 2014/59/EU, a liability shall not be excluded to the extent that:

i. *it is, or may become, unsecured in part, even if the liability was at the point of its creation fully secured, and*

ii. *the counterparty does not have an enforceable right to require the institution or relevant entity to provide additional assets, pledge, lien or collateral for the purposes of ensuring that the value of the liability from time to time does not exceed the aggregate value of the security or collateral.*

Article 3(3) of the draft RTS: liabilities issued or entered into after the transposition date

As currently drafted, Article 3(3) of the draft RTS states:

> *In point (d) of the first subparagraph of Article 55(1) of Directive 2014/59/EU the reference to liabilities issued or entered into after the relevant transposition date is to include:*
>
> *(a) liabilities created after that date under agreements entered into before that date;*
>
> *(b) liabilities under agreements amended after that date regardless of whether or not the liability is created after that date;*
>
> *(c) liabilities under agreements entered into after that date;*
>
> *(d) liabilities under debt instruments issued after that date.*

Sub-paragraphs (c) and (d) are uncontroversial from ISDA's perspective, although we defer to other respondents in relation to any impact on other products. However, the language in sub-paragraphs (a) and (b) gives rise to a number of interpretational difficulties and practical concerns for derivatives contracts (and no doubt liabilities in respect of other traded products as well). In particular:

It is worth highlighting a specific consideration in respect of derivatives, which derives from Article 49(2) of the BRRD, which provides that "Resolution Authorities shall exercise the write-down and conversion powers in relation to a liability arising from a derivative only upon or after closing-out the derivatives". The liability which is eligible for bail-in is therefore the net liability deriving from close-out. Such net liability is not referable to any one transaction under the relevant ISDA Master Agreement (or equivalent derivatives netting arrangement) and arguably is only "created" upon close-out. In the context of derivatives and the application of Article 55, therefore, it is not meaningful to conceive of multiple, individual liabilities under a single Master Agreement, notwithstanding that prior to close-out there were multiple individual transactions. The final RTS should clarify that the "liabilities" which are relevant for the purposes of Article 55 are those liabilities which may be subject to bail-in and, in the context of derivatives, this means only the net liability following a close-out.

In respect of sub-paragraph (a), ISDA submits that:

1) The mean of "created" lacks clarity. On the basis of the discussion at the Open Hearing, ISDA understands that the EBA does not intend for this to apply to, for example, transactions which were 'in the money' for the institution or relevant entity (and therefore assets) prior to transposition date but which become 'out of the money' (and therefore liabilities) after the transposition date. This should be expressly stated in the final RTS so as to avoid uncertainty.

2) The meaning of "agreement" lacks clarity. The ISDA Master Agreement operates as a single agreement governing all transactions entered into under it. In relation to each transaction, a separate confirmation will be issued, in each case at or about the time the transaction is entered into or (ideally) as soon as practicable thereafter. The economic terms of each derivative transaction will be set out in the relevant confirmation, not the Master Agreement. Collateral to be provided is determined by

reference to the net exposure of a party under the Master Agreement and is typically provided under a Credit Support Annex, which forms part of the Master Agreement. (There is one ISDA standard form document, the 1995 ISDA Credit Support Deed under English law, that, for purely technical reasons, constitutes a separate document. It is rarely used compared to the 1995 ISDA Credit Support Annex (Bilateral Form – Transfer) under English law. The other commonly used form is the 1994 ISDA Credit Support Annex under New York law.)

3) The entry into a new transaction could, on one view, be said to be an amendment to the "agreement" however, an amendment of this kind does not change the terms of the Master Agreement. For the reasons set out above, any provision required to meet the Contractual Recognition Requirement must be included within the Master Agreement, and made applicable to all transactions thereunder. Accordingly, ISDA considers that the "agreement" for this purpose must mean the ISDA Master Agreement.

In respect of sub-paragraph (b), ISDA submits that:

1) This exceeds the scope of the EBA's mandate and actually extends the scope of Article 55 to liabilities which would not otherwise be subject to the Contractual Recognition Requirement.

2) Again, the meaning of "created" and of "agreement" lacks clarity. See above.

3) The reference to "agreements amended" must, without some qualification, be read as referring to any amendments at all to the relevant agreement. This is not feasible. Building on our comments regarding the appropriate interpretation of "agreement", it is clear that the addition of a confirmation or new transaction under a Master Agreement should not constitute an "amendment" to that Master Agreement for the purposes of Article 55, nor should any amendment to the terms of an individual transaction. Only a re-negotiation of a term of the Master Agreement itself should constitute an "amendment" for this purpose.

What we need to avoid, ultimately, is that some liabilities entered into under a Master Agreement are subject to bail-in and others are not. This is because, to the extent that a close-out occurs under the Master Agreement, it must be a close-out of all of the liabilities under that Master Agreement. The RTS must therefore clearly provide that either the Master Agreement as a whole is eligible for bail-in or not at all.

2. Do you agree with the approach the EBA has proposed for the purposes of further determining the second subparagraph of Article 55(1) of the BRRD (which forms part of the list of liabilities to which the exclusion in Article 55(1) of the BRRD applies)?

As this is not specific to the derivatives market, we leave this point to be addressed by other respondents who will be considering, in their responses, the broader issues.

3. Do you agree with the approach the EBA has proposed with regard to the components of the contractual term required pursuant to Article 55(1) of the BRRD?

Yes, ISDA does agree with this approach. In particular, ISDA considers that it is appropriate to allow institutions and relevant entities maximum flexibility in drafting and implementing contractual terms for the recognition of bail-in in contracts governed by the laws of a third country. In light of the potential for different requirements under third country laws, and the broad scope of liabilities to which the Article 55 requirement applies, it is clear that an approach by which the draft RTS including a specific clause, or number of clauses, would not be practicable.

ISDA is primarily concerned with the operation of the contractual recognition terms under New York law (the vast majority of ISDA contracts are documented under either English law or New York) and considers that no specific changes to the elements of the contractual terms are needed in order to ensure that the term can achieve the necessary effect under New York law. However, the potential for different requirements under third country laws does mean that it is important that the RTS recognise that the precise formulation of each of the elements of the contractual term will need to be flexible. ISDA would suggest that the opening line of Article 4 of the RTS be amended as follows:

> *A relevant agreement shall include ~~as~~ a contractual term <u>which provides for</u> the following elements<u>, or the effect thereof in a manner which is appropriate under the relevant governing law</u>:*

As regards the elements of the contractual terms themselves, ISDA has two comments:

a) the formulation of the contractual term in the context of a guarantee could usefully be the subject of additional guidance. The actions which need to be recognised, and the manner in which a guarantee might be bailed-in in order to achieve the desired economic effect, may look very different in different resolution scenarios; and

b) we question the necessity for Article 4(5) (the **Entire Agreement Clause**). The intention appears to be that the Entire Agreement Clause is limited in its effect to those matters relevant to contractual recognition. However, it raises scope for confusion in circumstances where agreements, such as ISDA Master Agreements, incorporate confirmations that post-date the ISDSA Master Agreement itself. The requirement raises the possibility that there is in fact a valid consent to bail-in (complying with Article 55) but the entire agreement requirement has not been complied with, a scenario that would put an entity in breach of the RTS but without any detriment to the resolution authority or failure to comply with the Level 1 requirements. Again, ISDA submits that any concern on the part of the EBA regarding regulatory arbitrage is misplaced in the current environment, for the reasons described in response to Question 1 above.

4. Do you agree with the draft Impact Assessment? Can you provide any numerical data to further inform the Impact Assessment?

We have not, as a trade association, had the opportunity to conduct the necessary empirical work to enable us to contribute meaningfully to an evaluation of the draft Impact Assessment.

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Annex 1

ABOUT ISDA

Since its founding in 1985, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

Today, the Association has over 800 members from 67 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

The addresses of our European offices are as follows:

International Swaps and Derivatives Association, Inc.
c/o NCI Park Leopold Business Centre, 4th floor
38/40 Square de Meeûs
Brussels 1000
Belgium
Telephone: +32 (0) 2 401 8758
Fax : +32 (0) 2 401 8762
isdaeurope@isda.org

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD
United Kingdom
Telephone: +44 (0) 20 3088 3550
Fax: +44 (0) 20 3088 3555
isdaeurope@isda.org

Our registration number in the relevant EU register is 46643241096-93.

More information about ISDA is available from our website at http://www.isda.org, including a list of our members, the address of our head office in New York and other offices throughout the world and details of our various Committees and activities, in particular, our work in relation to financial law and regulatory reform.